JAG CAPITAL MANAGEMENT LLC

3rd Quarter 2019

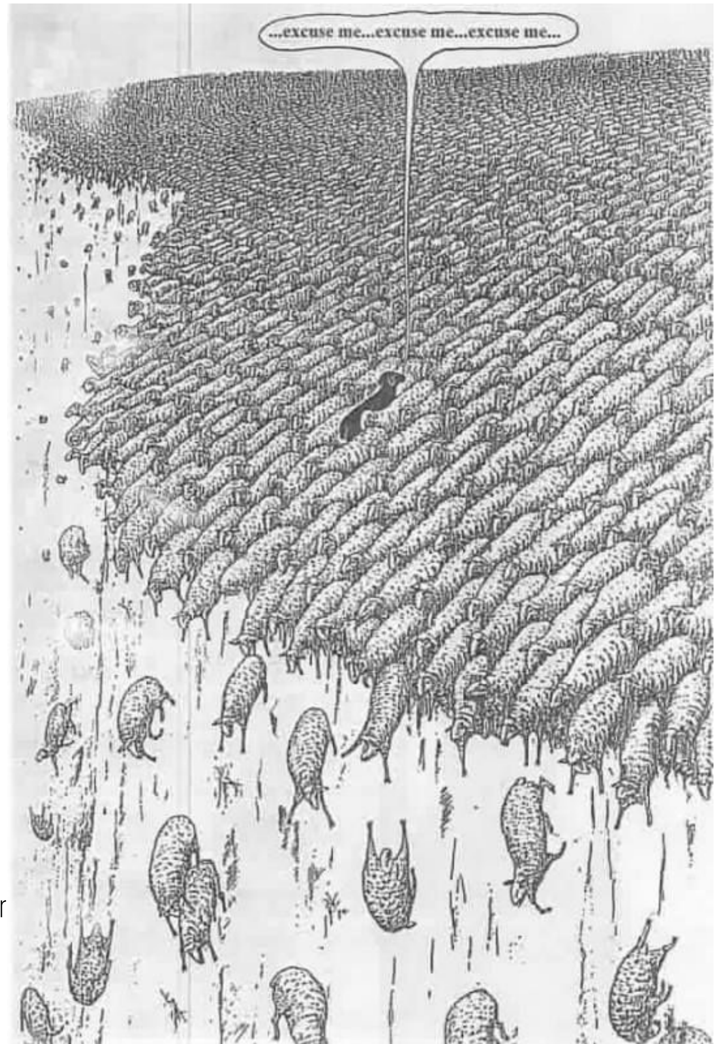
QUARTERLY COMMENTARY

EXCUSE ME

Although stocks are up nicely so far in 2019, the S&P 500 is trading essentially flat with levels it was at in January 2018. This lackadaisical performance over the past 20 months comes despite modest growth in corporate earnings, and it obscures a sharp 20% correction that hit the market hard during last year's 4th quarter.

When the broader stock market moves sideways for an extended period, it implies that investors are collectively indecisive about the future. And why wouldn't they be in late 2019? The political environment in the U.S. is as tendentious as it has been in decades, the United States remains in a trade war with China, global economic growth is slowing, and we are approaching what could prove to be a uniquely combative presidential election year in 2020.

Anxious investors have responded by retreating from stocks and plowing into bonds. According to Morningstar, investors pulled $60 billion out of U.S. stock mutual funds and exchange-traded funds last quarter, the biggest such move since 2009. Meanwhile, bond funds and money-market funds took in $118 billion and $225 billion, respectively.

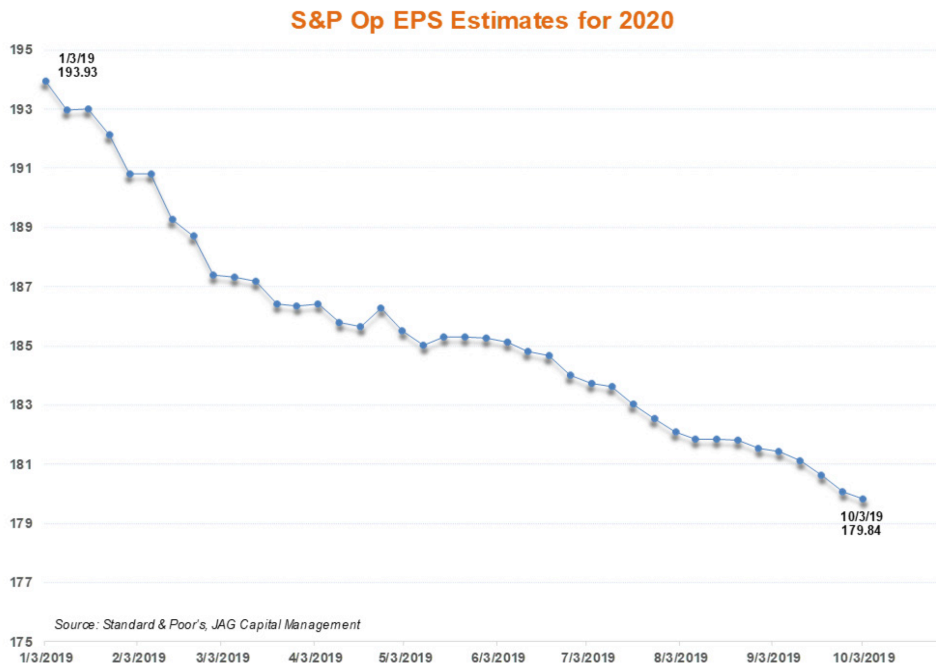


Print by Francois Kresz, 1974

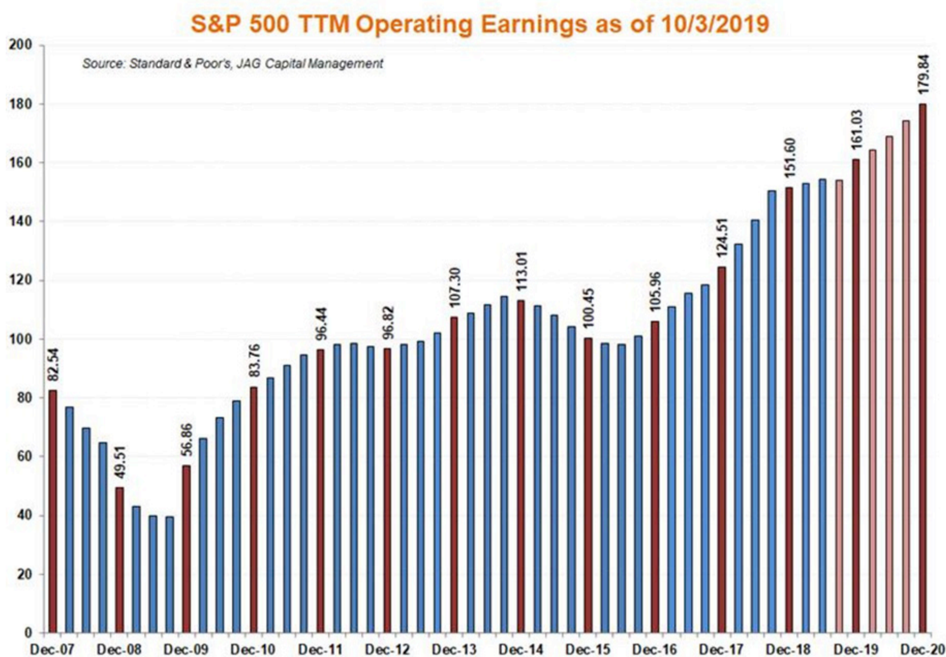
At risk of being pegged as the black sheep saying "excuse me" while moving against the traffic flow of the herd, this asset shift strikes us as irrational yet understandable. For long-term investors, now is probably a sub-optimal (irrational?) time to ramp up one's exposure to bonds. Yields are historically low, providing little cushion against the grinding effects of inflation. U.S. 10-year Treasury bonds currently yield approximately 1.7%, meaning that today's buyer would lose purchasing power over the next decade at any rate of inflation that approached the historical average of 2%-3% per year. On the other hand, the attraction of bonds is easy to understand. Bonds are easy to like right now, given their recently strong performance. Since bonds increase in value as interest rates fall, most categories of bond funds have done quite well over the past 12-18 months as global interest rates have fallen sharply. The Bloomberg Barclays Aggregate Bond Index returned 10.3% in the twelve months ending 9/30/19, soundly beating the S&P 500's 4.3% over the same timeframe. To the extent that investors traditionally tend to "herd" into the types of investments that have delivered the best recent returns, it makes sense that they are flocking into bonds. Time will tell if this is the best course of action looking forward, but we doubt it.

We previously discussed a summary list of some of the more common worries investors have about the financial markets and the economy. It is our sense that investors could be over-estimating the accuracy and magnitude of such headwinds. And, to the extent that some of these worries come true, it is likely that some of their prospective market impact will be dulled by the very fact that they have been discounted into current prices. In any event, we see several positive factors that could help offset the well-publicized negatives, including extremely low unemployment, ample evidence that the U.S. consumer remains robust, slow-but-steady domestic GDP growth, and generally healthy corporate profit margins.

We cannot claim to have any special insight into how this period of indecision will be resolved in the stock market. But in the spirit of the old saying, "Tell me something I don't know," we believe investors have potentially become too pessimistic on the outlook for corporate earnings. Recently we have seen several versions of the data reflected on this chart, which plots the evolution of 2020 consensus earnings estimates throughout 2019:



Notice how the line falls steadily from the upper left to the lower right over the course of 2019. Visually, this kind of chart implies that the outlook for corporate earnings in 2020 is bleak and getting bleaker. Is that an accurate assessment? To provide some additional context, this next chart lays out the estimated path of S&P 500 earnings over the last 2 quarters of 2019 and through 2020 (pink bars denote not-yet reported quarters):



Assuming earnings come in line with consensus expectations over the next six quarters, full-year 2019 S&P 500 earnings would be $161.03, and full-year 2020 earnings would clock in at $179.84. This equates to year-over-year earnings growth of roughly 12% between 2019 and 2020. Our perception of investor sentiment leads us to believe that many investors are not presently positioned to capitalize on the potential for double-digit earnings growth in the S&P 500 over the next year. Time will tell, but a potential gap between (low and declining) earnings expectations and (potentially strengthening) earnings fundamentals may be developing. If so, the closing of this gap could provide enough fuel for the stock market to stage an upside break-out after nearly two years of volatile, range-bound trading.

"We study, we plan, we research. And yet, somehow, money still remains more of an art than a science."

A potential 2020 recession is a well-known and well-covered wildcard for investors. If the U.S. economy does in fact slide into recession next year, then we can expect materially lower earnings for corporate America. And it is true that the risk of recession may be inching higher at the margin, given the ongoing trade tensions and the recent disappointing data from the ISM Manufacturing survey. But as we discussed earlier, there are several positive factors at play that make a contraction in domestic GDP anything but a fait accompli. We are cognizant of the fact that even the smartest and most diligent economists in the world struggle mightily – and often futilely - to predict the twists and turns of the global economy, interest rates, and inflation. For our part, we will stick to what we think we do best. Asset allocation, stock-picking and portfolio positioning have served us and our clients well through the years, and this is where we will continue to focus our energy and efforts. We see a variety of opportunities to move against the herd of consensus as we approach 2020.

Norm Conley
CEO & CIO

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